3724 West Avera Drive
PO Box 88920
Sioux Falls, SD 57109-8920
Telephone: 605.338.4042
Fax: 605.978.9360
www.mrenergy.com

Submission of

Missouri River Energy Services

Senate Finance Committee

Community Development and Infrastructure Working Group

Bipartisan Tax Reform

April 10, 2015

Tax-exempt bonds issued by states and localities serve as the cornerstone of community development and infrastructure. Changes that would limit or eliminate the exemption of interest earned on bond issues by state and local political subdivisions would:

- threaten economic development and growth;
- raise costs and tax burdens for local communities, their residents, and businesses; and
- produce a shortfall in essential infrastructure.

Missouri River Energy Services (MRES) urges the Community Development and Infrastructure Working Group to endorse continued treatment of tax-exempt bonds in any proposed tax reform initiative.

Tax Treatment of Municipal Bonds Rooted in System of Federalism

From the very beginning of our nation, the various rights of the individual states have been maintained as a central principle of federalism in the United States. Federal versus state or local taxing authority provided an early constitutional test. In 1819, Supreme Court Justice John Marshall wrote in the decision on McCulloch v. Maryland that states have no right to tax or otherwise "retard, impede, burden, or by any other manner control the operations of the constitutional laws enacted by Congress." In 1895, the Supreme Court found that the reverse was also true – that the Constitution does not allow the federal government to interfere with state and local governance by taxing interest on state and local bonds (Pollock v. Farmers Loan & Trust Co.).

Since the creation of the federal income tax in 1913, interest on government purpose municipal bonds has been excluded from federal income tax, just as interest on Treasury bonds has been excluded from state and local taxes.

Tax-Exempt Bonds Essential to Infrastructure Development

Tax-exempt bonds are the basic tool used by states, cities, counties, towns, universities, school districts, and other governmental entities to fund public purpose projects necessary to provide needed infrastructure and services. Today, three-quarters of the infrastructure investment in the U.S. is financed by state and local government bonds, including roads, bridges, sewers, hospitals, libraries, schools, town halls, police stations, electric and gas infrastructure for public power utilities, and every other government purpose investment made by state and local governments.

In turn, these facilities provide the foundation for business operations and growth, public health and safety, and quality of life for communities across the country.

Tax-Exempt Bonds and Electricity Service

As units of state and local government, MRES and its members have historically relied on tax-exempt bonds as the primary means of financing new generation and transmission.

The absence of tax-exempt financing would raise the cost to our consumers and jeopardize the economics of important power supply decisions. For instance, MRES is currently building the Red Rock Hydroelectric Project (RRHP) in Iowa. Electricity from this project is more expensive than alternative power supply options. Yet the Board of MRES chose to pursue this project because of its long-term economic value, operational attributes, and renewable characteristics. However, without tax-exempt financing, the project would cost an additional $240 million – and might not have been built.

The RRHP example highlights that tax policy cannot be made in a vacuum. The electric utility industry is undergoing significant change. For instance, the Environmental Protection Agency's proposed "Clean Power Plan" regulations will necessitate construction of numerous generation and transmission projects. Even without adoption of these regulations, plant retirements, state energy policies, and other regulations will require billions of dollars of needed infrastructure investment. If those energy policies are not supported by federal tax policies, the result will be economic dislocation for countless communities.

Tax-Exempt Bonds Provide Broad Economic Benefits

Some proposals to change the tax treatment of municipal bonds are grounded in a false assumption that any change will only impact the wealthy. This assumption is wrong on two fronts.

First, contrary to the perception that tax-exempt bonds only benefit high net-worth individuals, investors in all tax brackets benefit from tax-exempt bonds. In fact, according to the Internal Revenue Service, more than half of all municipal bond interest paid to individuals is earned by those with income of less than $250,000. Even if tax changes are targeted at upper-income taxpayers, the changes will impact all bondholders – regardless of income bracket – because the market for municipal bonds and the liquidity of that market will be eroded.

Second, changing the tax treatment of municipal bonds will disproportionately impact low-income individuals who disproportionately depend on the facilities and services financed with tax-exempt bonds and are least able to afford rate increases that changes in tax-exempt financing will necessitate.

Effective Alternatives Not Available

Tax-exempt financing is an essential tool for local governments. If tax-exempt bonds are eliminated or devalued, no effective alternative exists to fill the void.

1. **Municipalities Unable to Compete in Taxable Bond Market**

The corporate bond market includes only about 5,700 issuers. The entry point into the corporate bond market is typically $200 million, with the median corporate bond issue valued at $210 million. In some cases, the entry point in the corporate bond market has been much higher. For example, high-grade bonds issued in the corporate bond market averaged $500 million, with the smallest issuance at $100 million. Only about 5 percent of municipal bonds are issued for amounts of $200 million or more, with the vast majority of municipal bond issuances being much smaller – the median value is $7 million. Given the disparities, it is unlikely that local governments could compete with corporate entities for investors should Congress enact changes that would alter or eliminate the current tax treatment of municipal bonds.

2. **Problems with Tax-Credit and Direct-Payment Bonds**

Tax-credit and direct-payment bonds are sometimes touted as options that could replace tax-exempt bonds for municipalities. These instruments offer possible supplemental financing options to traditional tax-exempt bonds. However, they should not be considered substitutes for the more well-established and robust traditional tax-exempt financing options. These financing tools require periodic reauthorization by Congress and the terms and conditions are subject to change. Cuts to credit payments for Build America Bonds (as well as expiration of the program) are proof that these alternatives lack the certainty, durability, and confidence that exists for tax-exempt bonds. Moreover, tax-credit bonds appeal to a narrow pool of investors, and there is not a robust and liquid market for these instruments.

3. **Federal Appropriations are Not an Alternative**

At one point, state and local governments could count on a wide variety of federal programs to help pay for local infrastructure and service. Those days are long past.

We understand and accept that federal deficits mean that appropriations are not a viable option. But Congress should not compound the problem by transferring federal budget challenges to states and localities through alterations to tax-exempt financing.

Conclusion

As the Working Group considers options to promote community development and infrastructure investment, MRES encourages you to consider the following:

- The municipal bond market is well-established and provides stable and low-cost financing options for essential infrastructure projects;
- Tax reform proposals cannot be made in a vacuum and need to be assessed for all possible impacts on the economy and other federal mandates;
- Disruption of the current tax-exempt financing market would be detrimental for both issuers and investors alike;
- Contrary to the arguments of those advocating change, the burden of limiting or eliminating tax-exempt financing would disproportionately fall on lower-income individuals;
- Changes to tax-exempt financing would shift the burden of deficit reduction to state and local governments;
- Municipalities will likely be priced out of the corporate bond market if they lose the ability to offer tax-exempt bonds to investors;
- Tax-credit and direct-payment should not be considered as a substitute for traditional tax-exempt financing; and
- Absent retention of current tax policies for municipal bonds, state and local governments will not be able to provide essential services or infrastructure improvements to their citizens.